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RUEHLP/AMEMBASSY LA PAZ JUL 9951
RUEHPE/AMEMBASSY LIMA PRIORITY 0771
RUEHSG/AMEMBASSY SANTIAGO PRIORITY 2990
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TAGS: ECON EPET EINV
SUBJECT: REGULATION FOR HYDROCARBONS REFORM REVISED

REF: A. QUITO 1669
¶B. QUITO 1680
¶C. QUITO 889

¶1. (SBU) Summary: President Palacio issued a decree July 11 correcting the implementing Regulation of the April Hydrocarbons Law that had been published in the Official Register on June 29. The previous regulation offered potentially important opportunities for companies to mitigate the law's most draconian provisions, but the revised regulation swept those openings away. The law's constitutionality remains at issue, but no decision is expected by the court before the October elections. Former Minister of Economy Borja, Minister of Energy Rodriguez and Presidential Secretary Apolo reportedly disagreed on the law's regulation; the embarrassingly public dispute and disarray culminated in Borja's and Apolo's resignations (reftels A and B). Meanwhile, the GOE continues to lack any clear plan for the additional revenue generated from the Hydrocarbons Law and the Oxy seizure, raising fears of a spree of irresponsible spending and/or pilfering in the Palacio Administration's final months. End summary.

Previous Regulation at Odds With Hydrocarbons Law
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¶2. (U) President Palacio issued a decree July 11 to correct the Regulation of the Hydrocarbons Law that was published in the Official Register on June 29. The previous regulation differed in important ways from the Hydrocarbons Law, including Article 8 which allowed energy companies to mitigate certain elements of the reform, which former Minister of Economy Diego Borja concluded would reduce the GOE's fiscal receipts by more than $400 million this year. While the Hydrocarbons Law reform in April (reftel C) disregarded investment and calculated extraordinary payments to the GOE based on gross revenues, the June 29 regulation allowed companies to amortize investments if they had not already produced up to 40 percent of their proven oil reserves. Palacio's decree also eliminated three other articles and two supplementary clauses that changed the calculation of the reference price and required oil companies to turn over 60 percent of extraordinary revenues to the

state if they did not sign new contracts within 60 days.

¶3. (SBU) It is unclear why the Palacio Administration allowed the Official Register to publish the previous regulation. The Attorney General has initiated an investigation into who changed the regulation. Rumors within the government speculate that energy companies may have provided kickbacks to alter the regulation in their favor. Government sources tell us Borja and Minister of Energy Ivan Rodriguez, despite working together to rewrite the Regulation of the Hydrocarbons Law Reform, privately disagreed on how to address the discrepancies between the regulation and the law. Borja had congressional and industry backing for changing the regulation and eventually won out over Rodriguez, but not before sacrificing his job last week (reftel A).

Regulation Codifies Calculation of Revenue

¶4. (U) The revised regulation, published in the Official Register July 13, contains an equation to calculate the revenue-sharing mechanism which forces companies to share with the government all income generated by average monthly prices higher than those at the time the original contracts were signed. It specifies the government is entitled to at least 50 percent of the extraordinary revenue determined by the formula and requires the companies to submit monthly production and sales information. After Petroecuador calculates the additional payments, companies will have 30 days to deposit these funds into one of two accounts; proceeds from up to 23 API grade heavy crude will be funneled into the Special Account for Social and Productive Reactivation (CEREPS), while sales from superior crude will be deposited into a separate account at the Central Bank for use in the general budget.

¶5. (U) The regulation requires companies to make monthly payments to the GOE based on production, not sales, creating a timing problem for companies that normally produce over several months until they have enough oil to contract a tanker. Monthly payments based on production rather than sales will create a cash flow problem. In addition, companies are concerned that the regulation requires Petroecuador to define a reference oil price instead of using the actual price from individual transactions. Nor does the regulation clarify how these additional payments to the GOE will be treated under Ecuador's tax regime.

Constitutional Challenge Continues

¶6. (U) At the same time, the Constitutional Court has two cases pending questioning the constitutionality of the April Hydrocarbons Law. The Quito Chamber of Commerce and the Pichincha Chamber of Industry filed cases last month that allege the law violates contract sanctity by retroactively and unilaterally applying the law to current contracts. A decision on its constitutionality probably won't be addressed until after the presidential and congressional elections in October, so many companies will find themselves complying, giving the GOE 50 percent of additional revenue which could eventually be declared unconstitutional. If the court decides in the GOE's favor, U.S. companies can pursue international arbitration for violations to our Bilateral Investment Treaty after the six-month waiting period ends in October.

Companies' Perspectives

¶7. (U) The potential for legal challenges places foreign energy firms in limbo, obligated by the MOE to pay the additional revenues or be subject to fines, but acutely aware that under Ecuadorian law, firms which sign illegal contracts can face prosecution. Most companies expect the GOE will require them to abide by the terms of the law despite their unwillingness to sign contracts that have no legal basis.

¶8. (SBU) City Oriente, a small family owned U.S. company operating only one block along the Colombian border, remains stymied until the Hydrocarbons Law is either declared unconstitutional or the GOE retracts the law entirely. City refused to sign a contract with Petroecuador based on the now superseded regulation because it is unwilling to sign anything that could be found inconsistent with the Hydrocarbons Law. In the meantime, City released its two drilling rigs after declaring force majeure in April (reftel C) and will release the one remaining workover rig at the end of July. City continues to service its loans and is setting 50% of its revenues aside if required to pay the GOE. Barring exemption from the law, City informed the GOE of its two remaining options: terminate its concession with Petroecuador and be compensated under Ecuador's Constitution or convert their participation contract to a service or association contract. City plans to maintain their current holding pattern, if necessary, until February or March of next year. If the new regulation requires them to begin paying 50% of their revenues to the GOE, they will do so.

¶9. (SBU) Burlington Resources, recently purchased by Conoco Philips (the only other remaining U.S. company active in Ecuador's oil patch), is a 45% participant in two blocks operated by Perenco, a private French-owned company. Burlington's local manager expects that Conoco will eventually sell their small stake in Ecuador following the Hydrocarbons Law. Burlington and Perenco continue to drill in Block 7 but Burlington has ceased operations in Block 21.

¶10. (U) Andes Petroleum is reportedly waiting for the change of government in January, but will comply with any legal orders to pay 50% of their production to the GOE. Industry sources report that Repsol is eager to extend the term of its concession, and is the most likely to negotiate a new contract. Petrobras, on the other hand, is in a stronger position under Ecuadorian law as a state entity, and reportedly is disinclined to negotiate. Petrobras reportedly has its eyes on the ITT, a large, unexplored field that Ecuador has long considered offering in concession to a foreign oil company.

Lacking a Plan

¶11. (U) The GOE has no concrete plans of how it will use the additional hydrocarbons revenue. Estimates are as high as $800 million in additional revenue from Occidental's former fields and another $300-500 million from the new Hydrocarbons Law, implying additional oil-related revenue this year collected by the GOE of as much as $1.3 billion. Only the funds that enter CEREPS are restricted by the law that created it which requires 20% of deposits to go into an oil stabilization fund, and the remaining 80% is automatically allocated across sectors.

Comment

¶12. (SBU) Ecuadorian officials are violating several of their own laws in an effort to increase oil rents. Despite the provisions of the CEREPS, the government will probably have difficulty resisting pressure by powerful interest groups to increase current spending in the run-up to the October presidential election. The expected rise in current spending financed by these extraordinary oil revenues is likely to have a significant adverse impact on public finances over the medium term. There is an equally likely chance the Palacio Administration may attempt to line their pockets before departing, leaving behind empty coffers and a legacy of spending.

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